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UNCLAS SECTION 01 OF 06 JAKARTA 010359

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SUBJECT: INDONESIA'S FINANCIAL SECTOR POLICY PACKAGE

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losses of 70 percent last year over non-transparent pricing and risk, the package also calls for information transparency for banking products and other consumer protection measures. These include a standardized system for consumers to file complaints and the establishment of an independent dispute mediation body.

¶9. (SBU) Although Bank Mandiri and BNI lobbied BI to be allowed to establish special purpose vehicles that would take NPLs off their books, the policy actions will instead amend the rules governing NPLs. They will allow state-owned banks to work around state laws that have thus far prevented them from resolving bad loans using techniques commonly employed by commercial banks. Existing laws, such as the 2003 State Finance Law, treat state-owned banks assets as "state" assets. As a result, state-owned banks taking a haircut (loss) on non-performing debt or reselling it at a discount could be accused of causing a financial loss to the state, currently considered a criminal corruption offense. An international advisor at the Finance Ministry tells us that Bank Mandiri has been waiting for President Yudhoyono to sign the government regulation allowing state-owned banks to take haircuts on debt, which has been on his desk since the end of July.

¶10. (SBU) Getting rid of the NPLs is only half the battle, however. Resident expatriate economists note that because an excess of NPLs reflects a bank governance problem, bank management must be improved to prevent them from

accumulating anew. Besides allowing the state-owned banks to resolve NPLs using techniques employed by commercial banks, the Package also urges they emulate the more professional management practices of their private sector counterparts. The package calls for the State Ministry of SOEs to "ensure the commitment of state-owned banks' management to corrective measures in governance and risk management and to efforts for resolving problem loans." The medium specified for achieving this is the signing of management contracts on these subjects with the boards of directors of state-owned banks, a pretty weak mechanism for producing results.

¶11. (SBU) The Finance Ministry advisor characterized Bank Mandiri as "very cooperative" in reform efforts. A senior contact at Mandiri also pointed out that the bank's new president, Agus Martowardojo, had replaced all the group heads at the bank, which took months. In contrast, BNI is not replacing key staff, suspended an audit that was undertaken 18 months ago, and has a disengaged board of commissioners. The IMF notes that BNI is bloated in terms of personnel, at two-thirds the size of Mandiri, and unlike the latter is still non-transparent about its NPLs.

¶12. (SBU) An international banking consultant told us that it is not only the old legacy loans that are problematic, such as the Mandiri loans that have been the subject of headlines in the past year. New loans are going bad at a worrisome tempo because banks do not have proper risk assessment procedures. The consultant lamented that at least a third of Mandiri's employees are corrupt, incompetent, or both, and estimated that some 40-50 percent of new SME loans are going bad because Mandiri still does not have good risk managers or account officers.

¶13. (SBU) Though the Financial Sector Package aims to improve the banks, some debtors still have an attitude inherited from the New Order, when one of the perks of crony capitalism was that it was understood that state-owned bank loans did not always need to be repaid. Our senior contact at Bank Mandiri told us in confidence that after Bank Mandiri tried a "name and shame" strategy earlier this year, publishing the names of problem-loan holders, some debtors had started to pay, some were paying only interest, and some who could pay have a bad attitude and are refusing to. Mandiri's actions provoked a backlash from some companies that reached out to Palace contacts in an attempt to get the President to intercede, which he declined to do on advice of Finance Minister Mulyani. We heard a similar story about debtors with bad attitudes from the Finance Ministry

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advisor, who told us that Mandiri had "quite legally" seized a few cash deposits that were used as collateral on nonperforming loans. In one instance, the customer complained to the police, who hauled in several dozen Mandiri staff members including a director for questioning until 4 a.m. The advisor noted that in the past, Mandiri would have just made the problem go away by paying the police more than the client had, but now Mandiri's approach is to work things out through proper channels.

Bank Consolidation

¶14. (SBU) The Financial Sector package includes an item designed to encourage the consolidation of Indonesia's 131 banks required under BI's Indonesian Banking Architecture vision. The matrix calls for Bank Indonesia to provide "incentive" for banks to merge over the next two years, but does not explain what the incentive will be. BI has had trouble energizing its bank consolidation program, since the owners of small private banks like being bank proprietors, do not want to sell or close their banks, and are unlikely to respond to rational incentives. The large state-owned banks, however, have shown sustained interest over the past

year or so in merging with each other, raising the undesirable prospect of too much banking sector concentration in precisely the segment that is most poorly managed. BI has rebuffed these proposals. However, BI's recently announced "single presence" policy, if it goes ahead, would bar investors from holding a majority ownership stake in more than one bank. Designed to encourage consolidation (and possibly to mollify nationalists piqued at foreign investment in Indonesian banking), it is unclear whether the policy would apply to the government, which holds controlling stakes in the country's three largest lenders measured by assets-Mandiri, BNI, and Bank Rakyat Indonesia (BRI).

Next Up, Insurance Sector

¶15. (U) The third section of the package deals with non-bank financial institutions, with a marked focus on the insurance industry. (Note: Indonesia's insurance sector is in bad health and poorly regulated. Some domestic insurance companies were merely appendages of conglomerates. End Note.) The matrix calls for improved implementation of "Know-Your-Customer" principles across the non-bank sector; general moves to strengthen the pension fund sector, including drafting a development road map for the industry and good governance guidelines; and MOF decrees on strengthening the capital structure, regulation and supervision of finance companies and venture capital firms. Both insurance pension industries are underdeveloped in Indonesia, depriving the nation of good sources of long-term capital that could be invested in infrastructure. The insurance industry is small, according to the World Bank in January 2005, with assets equal to just 5 percent of GDP and 6 percent of total financial sector assets. The industry is also highly concentrated, with the ten largest insurance firms dominating three-quarters of the sector. The pension sector is similarly small, commanding only about 3 percent of financial system assets.

¶16. (SBU) Indonesia's insurance industry has made progress since international insurers Manulife (in 2002) and Prudential (in 2004), were declared "bankrupt" by the Indonesian court system on spurious grounds. Now the GOI is wrestling with genuinely bankrupt insurance firms, in particular, Bumiputra 1912, Indonesia's preeminent domestic insurance company. Bumiputra 1912 is "totally bankrupt," according to our insurance industry contacts, with premiums collected today being paid out tomorrow in claims. It should theoretically be shut down, but since it insures teachers and similar professions in the lower-to-middle class, the GOI is concerned about disruptive social consequences if the firm were allowed to fail. Upon discovering that Bumiputra 1912 is incorporated as Indonesia's only mutual life insurance company, the GOI made

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